Moscow Financial Weekly

For the week ending July 18, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Streamlined M&A regulations for banks adopted
- RTS slide continues as YUKOS uncertainty lingers

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R30.4367	0.16	-4.24
Monetary Base*	R1174.6 bln	2.32	24.92**
CPI	NA		
International Reserves*	$64.7 bln	-0.31	35.64
RTS Index (end of week)	437.20	-5.41	21.76
Refinancing rate	18	0	-3

*For week prior
** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

According to Goskomstat data, **industrial production increased by 6.8%** y-o-y during the first half of 2003, compared to 3.2% during the same period of the last year. Although June showed a slight deceleration of growth, production was up by 5.3% y-o-y and investment 12% y-o-y during that month, which is still strong. Growth in the first half of 2003 was still led by export-oriented industries such as fuel and ferrous metallurgy, which were up by 10% (1H) and 9.5% respectively. High oil prices allowed oil-extracting companies to make large capital investments (11.5% y-o-y for the first 5 months of 2003); this in turn revived the domestically-oriented machinery industry, which was up by 7.6% during the first half of 2003. The domestic-demand industries substantially lagged behind the leaders, with the exception of the food processing industry, which was up 4.3% during the first half of 2003. The overall favorable results of industrial production, in addition to increased private consumption, are reflected in recently announced GDP statistics. Minister for Economy and Economic Development Herman Gref noted that GDP for the first half of 2003 was up 7.2% y-o-y, compared to 3.6% for the same period last year.

Banking sector

The **volume of cash dollars** held by Russian households decreased during the first half of 2003 by approximately $2 billion, according to CBR First Deputy Chairman Oleg Vyugin. During this period the ruble became a very attractive asset due to the appreciation of the ruble vis a vis the dollar, so some residents opted to increase their ruble holdings, Vyugin explained. However, he cautioned that a $2 billion reduction is not material, given that the total volume of households' dollar holdings is estimated at several dozens of billions. Therefore, it is too early to talk about large-scale de-dollarization of the Russian economy, he said. According to CBR statistics, net demand for dollars from individuals in May totaled minus $135 million. That was the second time ever that sales of dollars by individuals exceeded purchases. (The first time was in September 2001 when net demand amounted to minus $42 million.) In May 2003, authorized banks imported $106 million into Russia, a record low since 1996 (the first year for which CBR statistics are available), and exported $377 million, which is also a record high.

The Ministry of Justice has registered a new CBR regulation designed to make the process of **mergers and acquisitions (M&A)** easier and less costly. It will come into effect on July 26. Consolidation in the banking sector is inevitable, and M&A is one of the ways to increase the efficiency of the banking sector, according to Mikhail Sukhov, Director of CBR's Department of Licensing and Financial Rehabilitation. He promised that the new document called "On Reorganization of Credit Institutions in Form of Mergers and Acquisitions" would significantly simplify bureaucratic procedures. In particular, the time given for the CBR to analyze respective documents is reduced from six to four months in case of a merger and from six to three months in case of an acquisition. In addition, banks will no longer be required to hold obligatory meetings with the CBR, nor will they have to produce a consolidated balance sheet approved by their AGMs. Sukhov said that so far in the history of Russia's commercial banks there have been only 35 M&A transactions, but he expects this number to start rapidly growing. (Investment analysts note the there have been only 2 mergers in the last two years.) He added that the CBR, together with MinFin were drafting an amendment to the law "On banks and banking activities" that would eliminate creditor's right to demand early repayment in the event two banks wish to merge, which is another major hurdle to bank mergers.

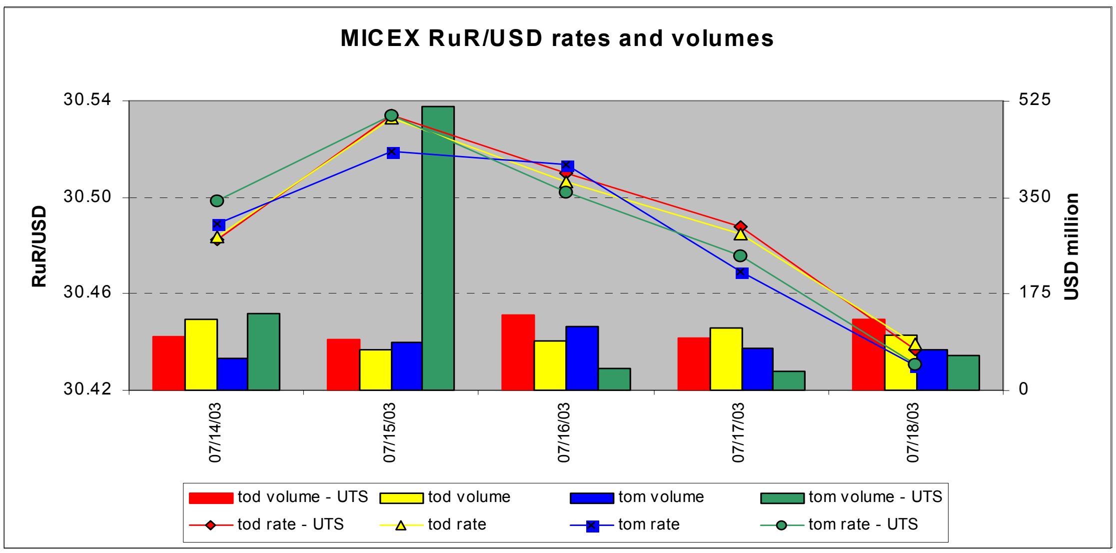
On July 18, **Sberbank** published an auditor's report on its 2002 IAS financial statements. Ernst & Young did the audit. Sberbank's net profit in 2002 reached R30.5 billion, its balance sheet total increased by 22%, compared to the 2001 figure of R1 trillion. First-tier capital was 14.7% and total capital (tier 1+2) ratio was at 16%. The net profit figure was below market analyst's expectations, and resulted mainly from a monetary loss derived from a specific IAS accounting calculation.

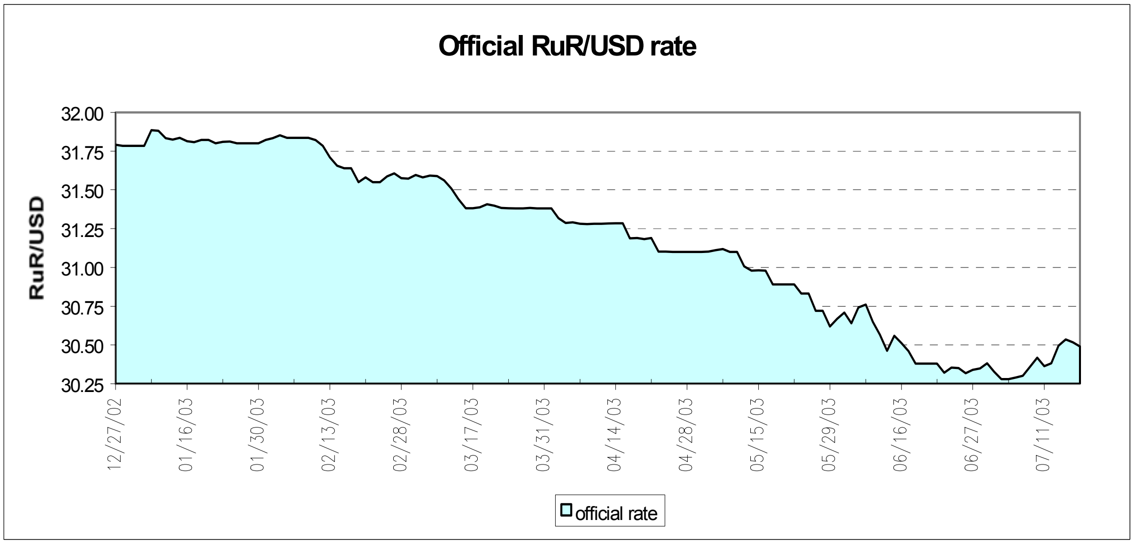
Financial markets

Forex Market

The week began with rapid growth of the dollar against the ruble, which continued until Wednesday, when the CBR launched a massive intervention at R30.535/$. The CBR sold at least $500 million that day to depress the demand for dollars. After that, ruble loan rates also went slightly up, which coincided with a moderate weakening of the dollar on international forex markets. As a result, for the last two days of the week the dollar was again sliding against the ruble.

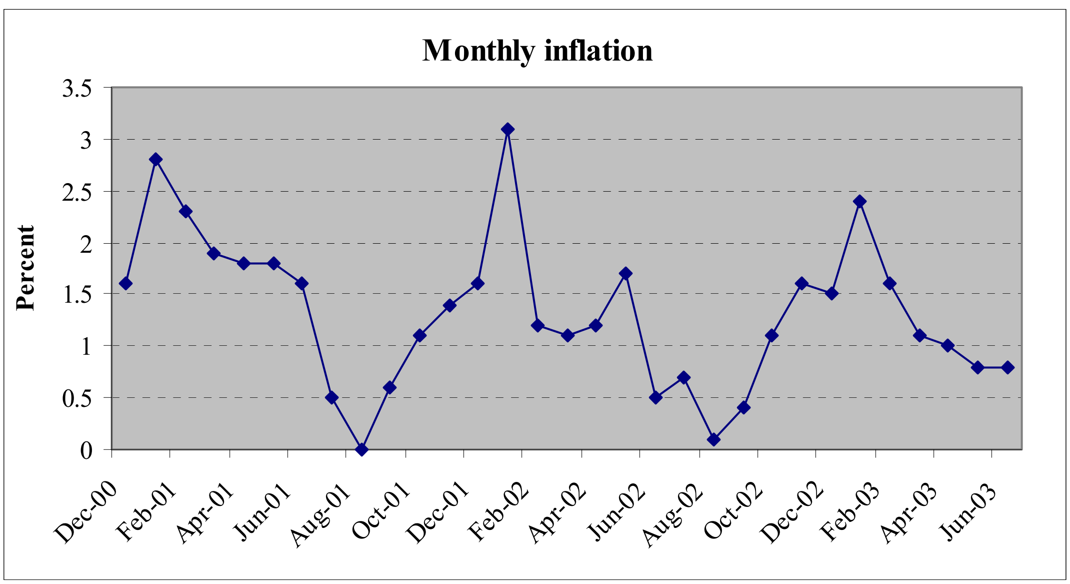
For the week, the dollar firmed 0.16% against the ruble, closing in the UTS "tod" on Friday at R30.4367/$. MICEX trade volumes were $550.98 million and $788.90 million, $502.09 million and $408.81 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively.





Prices

no new data.



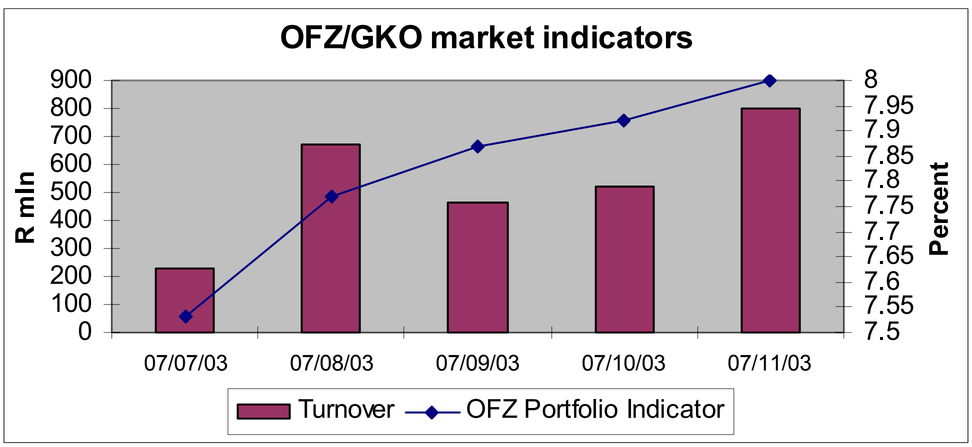
Eurobonds

Spreads on Russian Eurobonds widened last week, following the increase in U.S. Treasury yields that followed Fed Chairman Alan Greenspan's testimony to Congress. However, despite high and continuing volatility, Russian Eurobonds as an asset class have been less dramatically affected than equities by the YUKOS flap, their recent slide having begun before the crisis and their prices tied more directly to the movements of international interest rates and other emerging-market bonds. Nevertheless, the ongoing crisis continues to make itself felt. Some of the recent sell-off can no doubt be attributed directly to the YUKOS. However, investors are waiting for the placement of a new issue of over $1 billion of YUKOS Eurobonds. Before the Yukos situation began, demand for this issue was expected to be high, but market watchers now expect some kind of "political risk" premium. It will be interesting to see whether this risk will apply to other Russian corporate issuers in the near future, such as Magnitogorsk Metallurgical Combine, which plans to issue this fall.

Interest/Bond Market

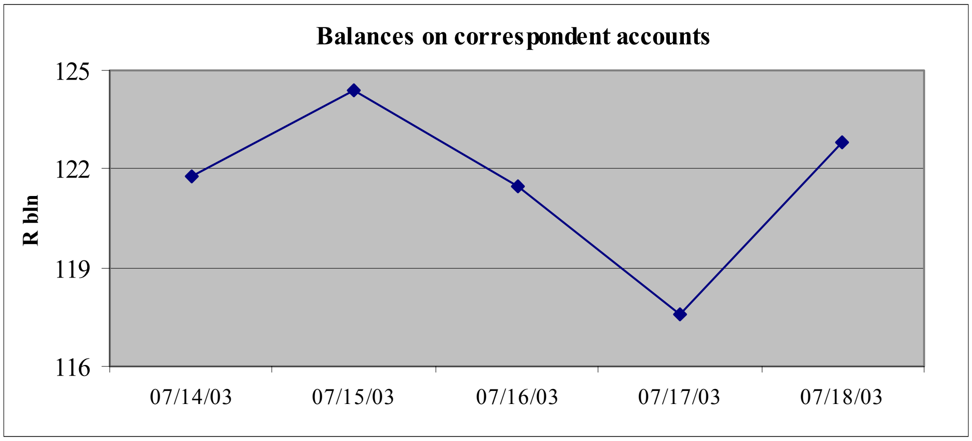
Bonds/Bills

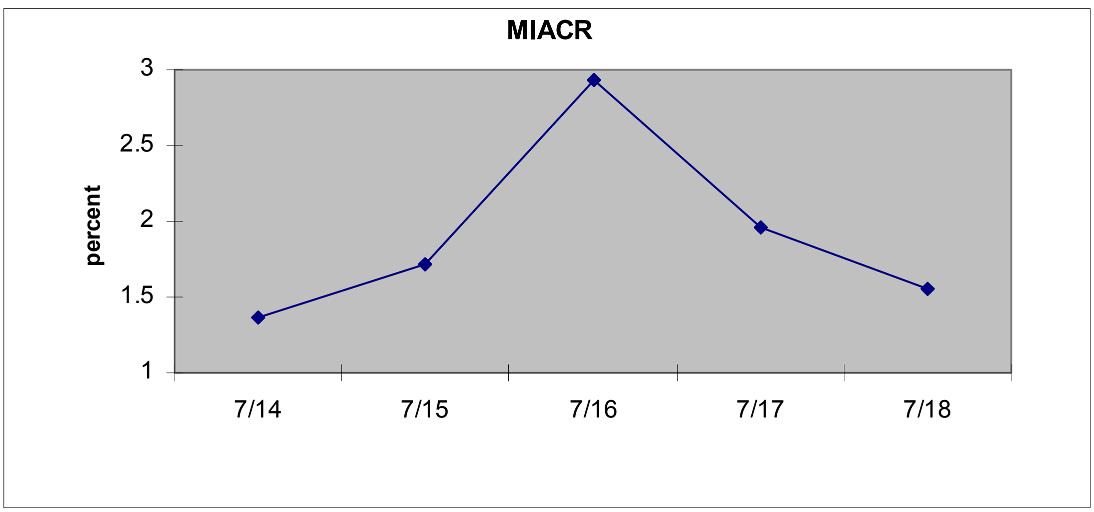
The appreciation of the dollar vis a vis the ruble, tighter domestic liquidity, and higher yields in the sovereign Eurobond market pushed the weakening secondary OFZ/GKO market further down last week. Another week of active selling ensued, with prices for OFZs maturing in two years falling by as much as 1-4% and yields exceeding 9%.



Overnight rates

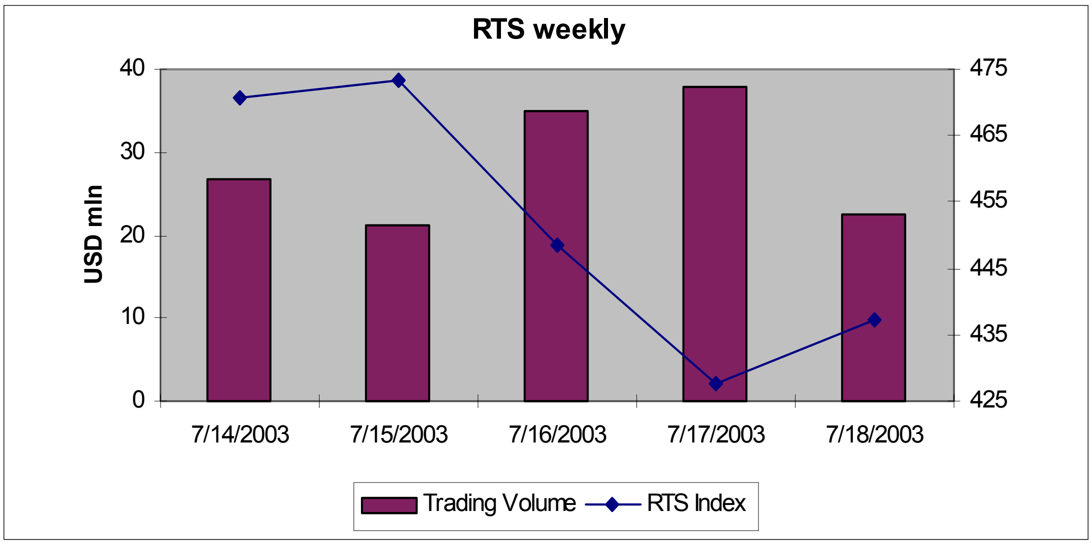
Ruble liquidity fell last week and fluctuated in the unusually narrow range of R117-124 billion. However, rates on the interbank market increased slightly compared to last week.





Stock Market

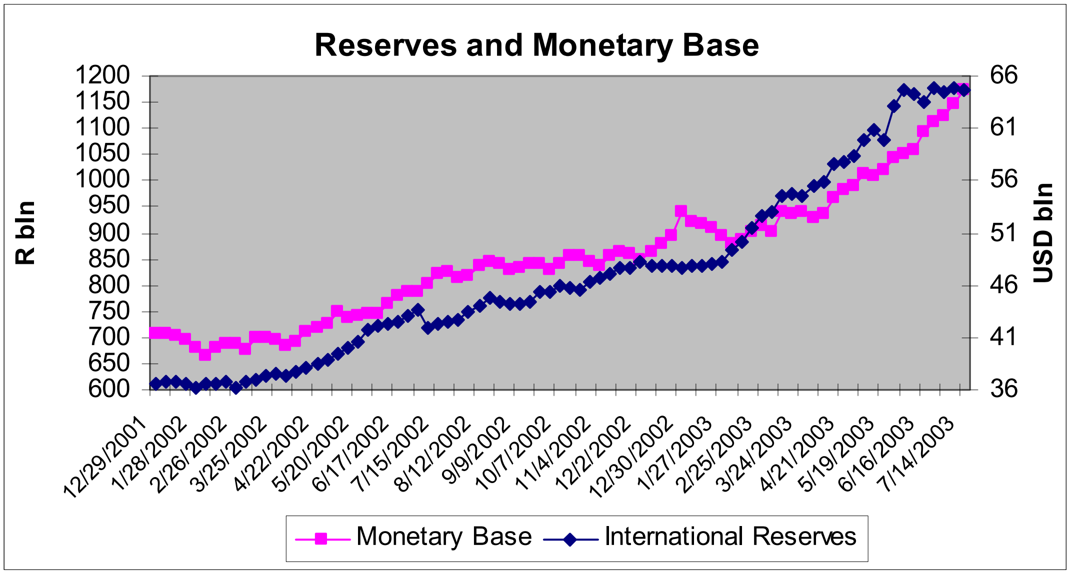
The Russian stock market started the week up after a sharp contraction the week before. On Tuesday, there was no clear-cut trend and the index was able to increase by a modest 0.55% on rather low activity. Many market players preferred to stay on the sidelines. However, by Wednesday, the bearish mood came back to the market and the RTS index sank rapidly: 5.19% for the day on active trading volumes. The initial cause was some contradictory statements by the Tax Ministry on some ominous threats about a major probe into Yukos that were subsequently toned down by the Tax Minister. The head of Yukos, Mikhail Khodorkovsky, back from his trip to the U.S., announced that Russian capital would exit Russia following the pre-election period. The panic sales were most intensive at the end of the day, when U.S. markets opened, and the RTS index slid below a psychologically important support level of 350 points. The next day the situation repeated itself with massive non-resident sales. On Friday, though, the market was able to recover slightly. The RTS index lost 5.4% for the week in real terms, but is still trading at 25% higher than it was just three months ago. The rather positive external news last week did not affect the market, which reacted primarily to domestic events surrounding the Yukos situation.



International Reserves and Monetary Base

The international reserves of the CBR decreased during the week ending July 11 by 0.31% ($200 million), to a total of $64.7 billion. Part of this is explained by a $124 million payment to the IMF; however in the recent past this would have been easily offset by higher inflows. Therefore, this drop could indicate the start of capital flight in reaction to the Yukos situation. On the other hand, the decline may also be due to seasonal effects, as the demand for dollars is stronger in the summer tourist season, when many Russians travel abroad. It may also be due to the impact from April's relatively low oil prices, which reduced the supply of dollars, and has now filtered through to international reserves.

The monetary base increased again, reaching a new high of R1174.6 billion as of July 14. This is R26.6 billion higher than the previous week's total.



EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS "tom" weighted average as of 11:30 becomes the "official" exchange rate for the next day. "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. **STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.